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REMUNERATION AND ESG: WHAT DO YOU NEED TO KNOW?

— THOUGHT LEADERSHIP

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REMUNERATION AND ESG: WHAT DO YOU NEED TO KNOW?

Tying executive remuneration and broader pay conditions to environmental, social and governance (ESG) measures continues to be a hot topic as the 2020-21 AGM and shareholder meeting season demonstrates.

Global events such as the COVID-19 pandemic, the climate emergency, economic uncertainty and social and racial justice are causing companies to accelerate changes to their ESG priorities, ensuring ever closer alignment between these issues and their long-term corporate strategies. Increasingly, companies' boards and remuneration/compensation committees are recognising that they too have a role to play in addressing these urgent challenges and are looking to manage the risks by linking them to conditions on executive pay. The level of interest in this area will only increase, as investors, consumers, staff and broader stakeholders put pressure on companies for a strong commitment to ESG, viewing pay as another way to hold companies and their executives to account.

Here's what you need to know about the current status of ESG and remuneration globally.

KEY ISSUES FOR COMPANIES

ESG measures are becoming increasingly prevalent and also a more significant part of bonuses and long-term incentive plans (LTIPs), certainly at executive level. Whilst a relatively small number of public companies have had ESG targets for remuneration purposes for some years, this has become an increasingly common feature over the last 12 months.

There are a number of key issues for companies, their boards and remuneration/compensation committees when considering ESG measures for pay purposes. These include:

- **Clear rationale and strategic link**
  As with any other performance conditions, it is essential that ESG measures are clearly linked to the implementation of the company's strategy. Setting ESG targets that have not been carefully considered, or adding an ESG target as an afterthought, can be counterproductive for businesses.

  Where ESG measures are used in LTIPs and bonus plans, most tend to be industry-focused, such as health and safety measures in the manufacturing sector and carbon emissions goals in the energy industry. However, increasingly, environmental concerns are being put at the forefront across sectors, reflecting the urgency of the climate crisis.

  It is important to be clear on motivations and objectives at the outset. It may be the case that companies want to adopt ESG targets for reasons of social pressure alone, regardless of whether shareholder value is being created. In these circumstances, care should be taken that the right balance is struck and consultation with shareholders in advance of implementation will be key.

- **Robust, measurable and quantifiable**
  ESG issues are constantly developing, often aspirational and long-term in nature, and so building these factors

into robustly measurable and quantifiable targets can be challenging. In evolving regulatory and legal landscapes, certain measures adopted at the point of grant may, for example, no longer be relevant at the end of the plan cycle.

As with any other target, tying measures to clear, reported and audited numbers will be more palatable to shareholders and other stakeholders. For this reason, companies commonly tie measures to identifiable outputs such as reductions in carbon emissions.

Careful planning will also be needed on the weightings, achievement and calibration of measures, which can also be challenging. Shareholders often view strategic measures as 'soft' and are wary where higher pay outs are achieved as against 'harder' purely financial metrics. Companies will need to take care that the measures are sufficiently stretching and are not achievable simply as ‘part of the day job.’ Realistic time frames for the achievement of targets will also have to be considered. Given the long-term nature of many ESG issues, is a meaningful assessment possible over the time frame that's being proposed?

- **Shareholder engagement and disclosure**
  Early engagement with shareholders and other stakeholders will be key to the success of implementation, especially where the ESG targets under consideration may not obviously tie to shareholder value creation. Enhanced disclosure in this area is also critical. Companies will want to link clearly the ESG strategy and method of performance measurement in their annual reports, proxy statements and other public disclosures. Investors expect a detailed rationale and disclosure of achievements that have led to the payment of any strategic and ESG elements. The weightings, achievement and outcomes of these strategic objectives should also be clearly disclosed and explained.

- **Extension into the wider business**
  Tying pay conditions to ESG should not be a board level issue only. Companies are increasingly thinking about applying ESG measures more broadly within their organisations, and not just at the executive level, in order to ensure a more meaningful and deeper cultural alignment with their strategic aims.

THE GLOBAL PERSPECTIVE

Comparing the use of ESG metrics for pay around the globe, there is a high degree of convergence in the way in which companies and stakeholders are approaching the issue.

The UK

Prevalence

Although companies have included ESG targets as part of executive pay in the UK for some time, this has commonly been within a ‘balanced scorecard’ type framework to be considered as part of a holistic assessment of performance, rather than having standalone ESG measures. ESG measures are, however, becoming a more material part of bonus and LTIP decisions.

A recent survey by the London School of Business showed that 45% of the UK's FTSE100 companies now have an ESG target linked to variable pay, with 37% including one in their bonus plans (with a typical weighting of 15%).

The nature of ESG targets adopted by UK companies is also evolving. Perhaps unsurprisingly, the more established metrics, largely relating to health and safety, risk, employee engagement and governance, are being boosted by newer measures, tied to diversity, social justice and environmental issues. We are seeing an increase in the introduction of climate change measures across all sectors and in financial services in particular, reflecting increased concerns from regulators and the real risk that climate change brings to the global financial system.

Investor position

Proxy advisers have been strengthening their guidance in the area and are very conscious of the challenges faced by companies. In their 2020 guidance, the Investment Association (IA), Institutional Shareholder Services group (ISS) and Legal and General Investment Management (LGIM) each recognised the impact of ESG risks and the benefit of incorporating ESG into pay structures. The IA, for example, is generally supportive: however it advises caution in ensuring that ESG performance targets are quantifiable and clearly linked to value creation and strategy. The IA is also clear that financial metrics should comprise the majority of variable pay determination, stating that a threshold level of financial performance will be needed before any award is made. Where some advisers are cautious in their views, others are actively pushing for ESG targets to be adopted.

The US

Prevalence and market practice

Increasing numbers of private and public companies in the US are incorporating ESG-related criteria into performance goals and targets for their executives.

We are aware of growing numbers of private companies that are beginning to include ESG targets in their executive compensation structures, but the best information available relates to public companies, and this discussion is based on public company data.

In a Pay Governance survey, 29% of respondents indicated that they were using some kind of ESG metric in their incentive plans in 2021, up from 21% in 2020. Pay Governance indicates that most are including environmental and social metrics. The survey also indicated that most who use ESG metrics do so in their bonus plans rather than in their LTIPs. This suggests that people have not yet determined what their long-term ESG goals are, or they anticipate that those goals and priorities will change.

There is some evidence that US companies which see themselves as having bigger environmental and social impacts are using ESG performance goals and targets. For example, one would expect operators in steel, cement, mining, energy and plastics to be at the vanguard of using environmental metrics.

There is increasing evidence of companies using metrics that consider human capital, diversity and inclusion considerations.

Public companies are not specifically required to discuss ESG in their executive compensation disclosures, but the relevant rules do require that companies explain in detail how performance compensation for the named executive officers is set and determined.

Companies that have included aspirational language in SEC filings about ESG have faced lawsuits from plaintiffs who allege that actual behaviour has fallen short of what had been promised in a formal securities law filing. Most companies take the responsibility for what they say in SEC filings quite seriously, and a review of recent annual proxy statement filings with the SEC shows a great deal about ESG trends in compensation:

Starbucks reports using individual performance factors in annual bonus determinations for senior vice-president and above, to help drive achievement of diversity and inclusion targets. Starbuck's leadership stock plan includes a performance metric that ties payouts to "improvement in Black, Indigenous and LatinX representation at the manager level and above, with a three-year target of improving Black, Indigenous and LatinX representation by more than 5% by 2023."

Intel discloses that the annual bonus for named executive officers is based, in part, on achievement of ESG "metrics encompassing environmental and diversity and inclusion goals."

TreeHouse has "included progress against ESG metrics in the merit component of executive officer compensation and progress on key diversity and inclusion metrics in the strategic component of their annual incentive plan for executive officers."

Callon Petroleum adopted ESG metrics for the 2021 annual bonus with a 15% quantitative weighting plus a qualitative component tied to sustained progress towards greenhouse gas reduction targets. It also uses metrics related to safety, environment, diversity and team development.

Walt Disney disclosed that the 2021 annual bonus will "further highlight ESG metrics, by emphasizing diversity and inclusion (e.g. representation, retention and content), which will have the highest weighting among non-financial metrics."

The EU

ESG is high on the agenda of law makers and is beginning to make its way into policies of EU based investors and companies.

Rapidly evolving regulations

The European Commission has demonstrated itself to be a pioneer in ESG law making on remuneration. It has introduced various new initiatives and regulations, both in relation to the remuneration of executives and the wider employee base.

In February 2021, the consultation on the Commission's questionnaire on sustainable corporate governance closed. The questionnaire built on an earlier study of the European Commission on director's pay and looked into new measures to avoid short-term gain and to increase alignment of remuneration with companies' long-term goals. Assuming this leads to a European Directive on sustainable corporate governance, the impact on board remuneration structures may be significant, as requirements on executives' pay may include: mandatory deferral periods, restrictions to sell shares that are awarded as variable pay, and compulsory inclusion of non-financial, ESG metrics linked to a company's sustainability targets.

In March 2021, the Commission published its new proposals for a European Directive on pay transparency. The lack of pay transparency has been a thorn in the side of the Commission as it is seen as one of the main obstacles to ensure equal pay between men and women and pay gap issues in general.

The proposal includes a right for workers to know the pay levels of other workers doing the same work and an EU-wide gender pay gap reporting obligation for companies with at least 250 workers.

Finally, on 21 April 2021, the Commission published its proposal for a Corporate Sustainability Reporting Directive, which would increase the reporting requirements and the number of companies in scope of reporting from 11,600 (currently in scope of the Non-Financial Reporting Directive) to approximately 49,000 (in scope of this new Corporate Sustainability Reporting Directive). Reporting requirements will include equal opportunities, including gender equality and equal pay for equal work, training and skills development, in addition to requirements on working conditions, including secure and adaptable employment, wages, social dialogue and the involvement of workers.

The fast pace at which the Commission is initiating new proposals for ESG regulations, including on pay, demonstrates that the Commission is serious about its ambitions and companies will need to adapt swiftly to keep up with the changing environment.

Market practice

Under the pressure of soft laws on corporate governance, local market authority regulations and proxy advisors recommendations, a large number of European listed companies already incorporate ESG metrics in their executive officers' annual bonus. The weight of the ESG metrics in LTIPs is also growing.

According to the 2020 report on ESG metrics published by Willis Towers Watson 68% of the top European companies use at least one ESG metric in their annual bonus, LTIP, or both.

Investor position

In addition to investment group Cevian, which has pushed hard for the inclusion of ESG metrics, we are also seeing other investors in the EU emphasising the importance of ESG in relation to remuneration. In its 'voting policy and 2021 engagement', Amundi Asset Management 'voted against executive compensation plans that did not contain ESG indicators, resulting in 31% of negative votes on this issue.' Also Dutch APG Asset Management, critically monitors the remuneration policies of its investment companies and has called for the 'inclusion of ESG objectives in remuneration policies.'

APAC

Australia

Non-financial measures, including ESG, are a substantial – and an increasing – factor in corporate remuneration frameworks in Australia. The emergence of ESG as a factor relevant to determining incentives is a relatively recent trend, and can largely be attributed to a shift in regulatory focus and public sentiment following the Hayne Royal Commission into the Banking sector, and inquiries by the Australian Prudential Regulation Authority into culture, governance and accountability at a number of Australia's largest financial institutions.

A report released in January 2021 by Guerdon Associates found that Australian companies pay more for positive ESG outcomes than any other country involved in the study, with 81% of ASX100 companies incorporating ESG metrics in their CEO's remuneration framework compared with 67% globally. Amongst the Australian companies surveyed, non-financial incentives were 30% of the overall incentive opportunity, compared with 20% globally.

In the future, ESG looks set to be an increasingly important metric for executive remuneration in Australia. Shareholders are demanding action on climate change through a move away from traditional Australian investment in non-renewable energy sources, and as a result of increased social awareness of social, governance and cultural issues.

Hong Kong

The Hong Kong Stock Exchange's (HKSE) Listing Rules contain a Corporate Governance Code and ESG Reporting Guide, requiring governance and oversight of ESG matters and assessment and management of material ESG risks, as well as reporting on listed ESG topics on a comply or explain basis and disclosure regarding governance of ESG issues. They do not, however, require or recommend the inclusion of ESG metrics in incentive plans and there is no sign of such a recommendation in the public consultation launched this month.

Similarly, whilst culture reform through incentive systems is very much on the Hong Kong Monetary Authority's (HKMA) agenda and the HKMA has formed a Green and Sustainable Finance Cross-Agency Steering Group with the Securities and Futures Commission (SFC), there is no requirement or recommendation for ESG metrics in incentive plans on that front either.

Whilst ESG metrics are used within reward structures in Hong Kong, this is not standard practice. ESG metrics tend to relate to the environment, such as CO2 reduction and sustainability measures such as safety and customer satisfaction, and are typically linked to annual bonus. An example is China Light and Power (CLP). CLP takes a balanced scorecard approach and the measures taken into account include safety performance (fatalities, lost time injury and injury rates) and environmental performance (regulatory non-compliance, CO2 intensity, and emissions and renewable energy capacity). Other companies that have disclosed incentives for management of climate-related issues under the not-for-profit Carbon Disclosure Project are MTR Corporation and New World Developments.

Willis Towers Watson's survey indicated further adoption of ESG measures in the future. The results stated that, in APAC, seven in ten respondents are planning to change how they use ESG within their executive incentive plans over the next three years with 69% planning to introduce ESG measures into their LTIPs over the next three years, and 61% planning to do the same with their annual bonus. Respondents say that amongst the greatest challenges faced when using ESG metrics in incentive plans, are target- setting (46%), performance measure identification (37%) and performance measure definition (34%). This explains the importance of performance measures having a clear rationale and strategic link, and be robust, measurable and quantifiable.

Japan

The integration of non-financial measures including ESG into remuneration frameworks for executive officers has become an urgent issue for Japanese companies. ESG has recently become an important financial incentive for executives in Japan, following global trends in non-financial measures.

In Japan, the promotion of ESG has been steadily improving, starting with the formulation of a Corporate Governance Code and a Stewardship Code. The Ministry of Economy, Trade and Industry (METI) revised guidelines regarding corporate governance systems in 2018, stating that "environmental, social and governance (ESG) factors are becoming increasingly important for investors and shareholders in assessing a company's sustainable growth and medium-to long-term corporate value enhancement."

Some Japanese companies are beginning to introduce ESG factors as a performance evaluation item in executive remuneration, but they are still in the trial stage, with non-financial measures accounting for as little as 10% of executive remuneration and relying on evaluations by external evaluation agencies. However, as society becomes increasingly aware of the need for proper corporate governance, ESG will become increasingly important as an indicator of executive remuneration and more companies are likely to introduce new remuneration frameworks that take ESG into account. According to a survey published by Deloitte Tohmatsu and Sumitomo Mitsui Trust Bank in November 2020, 5.4% of large Japanese companies used ESG indicators in determining executive remuneration whereas it was only 3.6% in the previous year.

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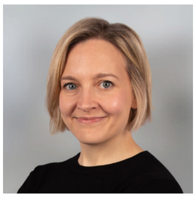

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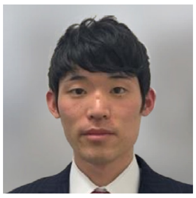

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